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New Zealand

Dairy and Products

Milk Production on the Rise

2009

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Report Highlights:

New Zealand milk production is forecast to increase 8% in MY 2008/09 compared to the drought affected MY 2007/08. New Zealand dairy export volumes fell 9% during the first seven months of MY 2008/09 compared to the same period last year. The biggest falls were in cheese, butter and butter oil, and whole milk powder; down by 21%, 10% and 4%, respectively. The drop in export volumes has resulted in a supply chain problem for Fonterra and several newspaper articles have reported on the challenges Fonterra is facing to secure adequate storage space. According to Agricultural Affairs Office estimates, New Zealand's inventories of dairy products have approximately doubled since mid-year 2008 to somewhere in the range of 340,000 to 370,000 metric tons. Over the last few years, three new milk processing companies have started production in New Zealand and approximately three more are expected to come on stream within the next few years. As a result, Fonterra's share of milk collected in New Zealand has slid from 94% to an estimated 91.5% in MY 2008/09. If all of the new processors coming on stream achieve their business projections, Fonterra's share could slip further to between 85 and 87% within five years.

Includes PSD Changes: No
Includes Trade Matrix: No
Trade Report
Wellington [NZ1]
[NZ]

Executive Summary

New Zealand's dairy sector has recovered from last year's devastating drought and milk production is comfortably ahead of last year. Pasture conditions, weather patterns and herd numbers suggest the industry is on track to produce 8% more milk in MY 2008/09 (June 1/May 31 year) reaching a record 16.35 million metric tons. However, the continued slide in dairy commodity prices, drop in export levels, and build up in stocks are a growing concern for the New Zealand dairy sector and the New Zealand economy. Dairy exports account for over a quarter of New Zealand's total merchandise exports and approximately 7.5% of GDP.

New Zealand dairy export volumes fell 9% during the first seven months of MY 2008/09 compared to the same period last year. The biggest falls were in cheese, butter and butter oil, and whole milk powder; down by 21%, 10% and 4%, respectively. The drop in export volumes has resulted in a supply chain problem for Fonterra, New Zealand's largest dairy cooperative. According to Agricultural Affairs Office estimates, New Zealand's inventories of dairy products have nearly doubled since mid-year 2008 to somewhere in the range of 340,000 to 370,000 metric tons. However, in recent media reports, Fonterra executives have signaled that inventories have turned the corner and are now being run down.

On January 28, 2009, Fonterra announced a 90 cent reduction in its projected payout price to NZ \$5.10, down from a revised forecast of NZ \$6.00 in November and an initial forecast of NZ \$7.00. The new payout of NZ \$5.10 compares to the 43-year inflation adjusted high of NZ \$7.90 paid out last season. Fonterra pointed to the global oversupply of milk and the weak global economy as reasons for the decline in the projected payout. The downward revision in the payout price will shave off over 1% of New Zealand's gross domestic product (GDP). While still above historical levels, the lower payout combined with increased difficulty in obtaining credit will put a squeeze on farmer cash flow, especially that of farmers who have entered the industry recently. Taken together, these factors will likely impact on the rate of expansion of the dairy industry which, measured on the basis of milk solids produced, has more than doubled since 1990. (Please see GAIN Report NZ9001 for additional information.)

Fonterra implemented a controversial auction system for whole milk powder (WMP) in July 2008, which has fast become an industry-accepted reference price. Since the system was implemented, the average selling price for whole milk powder has plummeted 58% from US \$4395 per ton to US \$1,851 on February 4, 2009. Internet auction prices fell 14% in December's auction, a further 9.3% in January, and an additional 8.2% in February's auction. Competing dairy companies have complained that the auction system has accelerated the decline in prices arguing that it has turned Fonterra from a price-maker into a price-breaker. They have also suggested that Fonterra is using the auction system to enhance its position with New Zealand dairy farmers by strengthening its dominance over the growing number of competing dairy companies and to compensate for the poor performance of its added-value business. According to Fonterra, the auction system is working well. In a recent statement, Fonterra representatives said that it is achieving what it was developed for – enabling price discovery of commodities in an increasingly volatile market. However, in response to the most recent auction, the New Zealand Herald reported a Fonterra executive as saying "Prices should be very attractive to buyers at these levels, and they are not sustainable for global suppliers." While many analysts have indicated that the market is close to finding a floor, the recent announcement by the EU regarding the reactivation of export subsidies could drive prices down further.

Over the last few years, three new milk processing companies have started production in New Zealand and approximately three more are expected to come on stream within the next

few years. As a result, Fonterra's share of milk collected in New Zealand has slid from 94% to an estimated 91.5% in MY 2008/09. If all of the new processors coming on stream achieve their business projections, Fonterra's share could slip further to between 85% and 87% in five years.

Production

Milk Supply Forecast to Increase

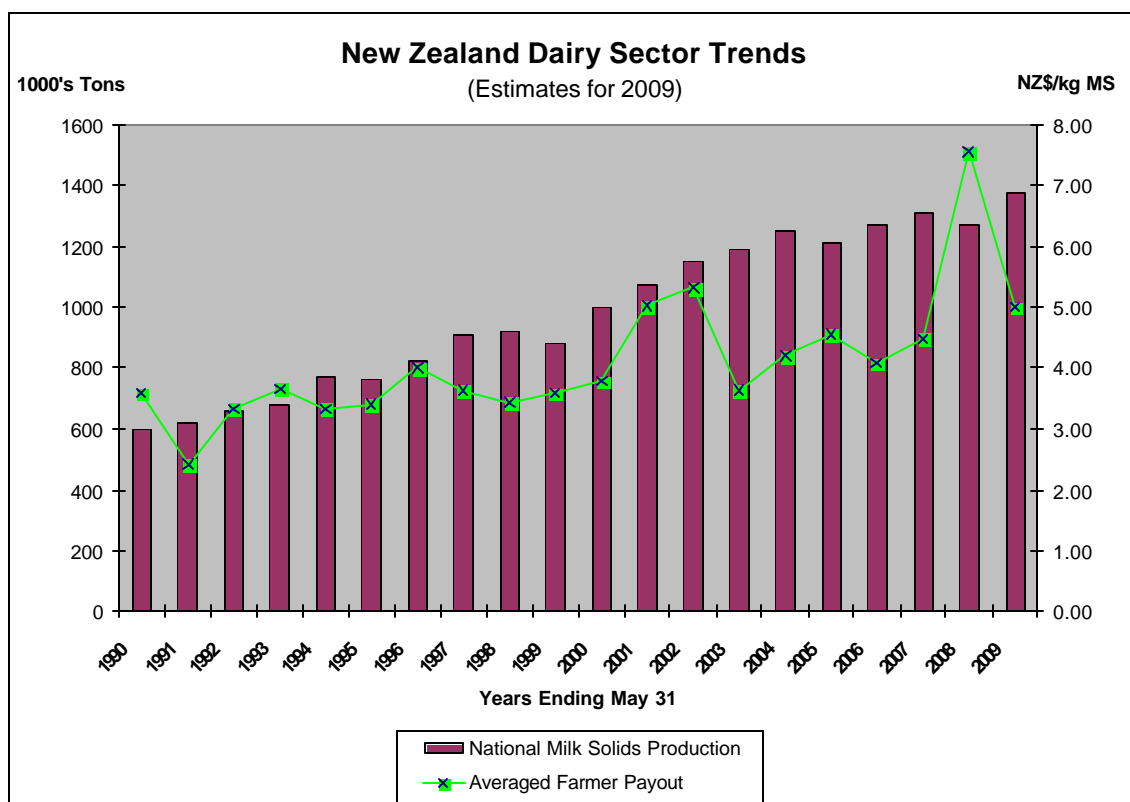
While some industry analysts expect New Zealand milk production to increase between four and six percent during the MY 2008/09 season, the Agricultural Affairs Office believes the increase will be more on the order of 8%. Production during the first half of the season is comfortably above the level achieved at this point last year. While there are currently some dry regions in New Zealand, they tend not to be in dairy producing regions. In addition, pasture growth is good, there is a good supply of supplemental feed on hand, and normal amounts of rainfall are projected over the next three months with perhaps slightly higher temperatures than average. These factors, combined with approximately 4% more cows being milked than last year, suggest the industry is on track for a record year. Post's production forecast remains unchanged at 8% ahead of MY 2007/08 year. (Please see GAIN report NZ8026 submitted in October 2008 for additional information.)

Fonterra Cuts Projected Producer Payout

After several years of increasing dairy commodity prices, Fonterra is facing a difficult environment characterized by a significant drop in global dairy prices, the effects of the global credit crisis, a fluctuating New Zealand dollar, and increasing domestic production. Fonterra's major cost of business is purchasing milk from its 10,724 farmer shareholders. On January 28, 2009, Fonterra announced a 90 cent reduction in its payout price to NZ \$5.10, down from a revised forecast of NZ \$6.00 in November and an initial forecast of NZ \$7.00. The \$5.10 payout is expected to be broken down to a milk price of NZ \$4.65 and a value return forecast of 45 cents, 5 cents more than the last prediction. During the 2007/08 season, the payout price reached a 43-year inflation adjusted high of NZ \$7.90. When announcing the revised milk price, Fonterra Chairman Henry van der Heyden said the lower forecast reflected the continuing decline in international commodity prices coupled with the ongoing effects of the global financial crisis.

The country's second biggest dairy co-op, Westland Milk Products, has already slashed its forecast milk payout to its 380 dairy farmers from a range of NZ \$6.70 to NZ \$6.95 at the season's start to between NZ \$4.10 and NZ \$4.50. Last season, Westland's payout was NZ \$8.24, which was 34 cents ahead of Fonterra.

Based on last season's collection of 1.19 billion kilograms of milk solids, the 35% cut in Fonterra's payout price, as compared to last season, will shave off over 1% of New Zealand's gross domestic product (GDP). While still above historical levels, the lower payout, a higher cost structure, and increased difficulty in obtaining credit due to the global credit crunch, will put a squeeze on farmer cash flow, especially that of farmers who have entered the industry recently. Taken together, these factors will likely impact on the rate of expansion of the dairy industry which, measured on the basis of milk solids produced, has more than doubled since 1990.



Sources: Ministry of Agriculture and Forestry, Livestock Improvement Corporation, Statistics New Zealand, and FAS Estimates

Dairy Conversions Slow Down

During the last quarter of CY 2008 when the projected payout was in the NZ \$6 range, analysts were still predicting around 200 new dairy farms (mostly conversions from sheep and beef to dairy). However, given the current economic conditions and the drop in the projected producer payout to NZ \$5.10, some of the expected conversions will not take place.

On-Farm Operating Costs Increase

There has been a fairly steady increase in on-farm costs over the past few years. According to Statistics New Zealand, farm input costs, including livestock, have increased 15% from the first quarter of 2006 through the second quarter of 2008. Dairy New Zealand, an industry organization funded through a national levy program, estimates that dairy farm input prices increased 10.2% during MY 2007/08 year, which is significantly higher than the ten-year annual average of 2.5%. Dairy New Zealand also estimates that on farm inflation will be between 5% and 6% for the MY 2008/09 season.

While New Zealand's dairy sector is pastoral based, there appears to be an ongoing trend toward increased utilization of inputs, such as nitrogen fertilizer for pasture growth, and supplemental feed, such as grain and maize silage and palm kernel extract. The increased use of inputs combined with input price inflation is driving the on-farm cost structure upward and making it more difficult for dairy farmers to achieve a profit.

Outlook for Future Production

Since 1990, New Zealand dairy production has grown at an average annual rate of 4%. If viewed from 1995, the average annual rate has been on the order of 3.6% and, since 2000, 2.6%. Annual milk production growth over the next five years is expected to be on the order of 2% to 4%. Future growth will be tempered by profitability factors, along with other considerations including the level of investment in research and extension and environmental policy developments, such as the emissions trading scheme.

New Processors in the Dairy Sector

In New Zealand, the dairy processing industry is dominated by Fonterra Cooperative Ltd, collecting an estimated 91.5% of the milk supply during the current marketing year, down from 94% last year. The other main processing cooperatives have been Tatua and Westland, however, a number of investor-owned companies have entered or announced the intention to enter the market. Some of these companies have fairly ambitious expansion plans. If their business plans are achieved, Fonterra's share of the market could drop to between 85% and 87% by 2013.

Over the next few years, Open Country Dairy (OCD) will likely become Fonterra's biggest rival. OCD is a subsidiary of AFFCO, a meat cooperative, and partly owned by Singapore-based global dairy trading company Olam International. Originally launched in March 2007 as Dairy Trust, it recently purchased Open Country Cheese, the first independent cheese maker to open in New Zealand after the industry was deregulated in 2001. Based in the Waikato region of the North Island, OCD is producing cheese, butter oil and a range of milk and whey powders for sale in New Zealand, Australia, South East Asia, Latin America, West Indies, Russia, the United Kingdom, Morocco, Algeria, Egypt and Saudi Arabia.

Fonterra Percentage of Milk Processed		
(Millions Kilograms of Milk Solids)		
	Estimated Milk Processed 2008/09 Season	Estimated Milk Processed 2012/13 Season 1/
Non-Fonterra Processors	116.9	214
Fonterra	1,256.1	1,396
Total	1,373	1,610
Fonterra Percentage of Total	91.5%	87%

1/ Does not include Mataura Valley Milk and Ingredient Solutions, which have not yet started production.

Note: Estimate for non-Fonterra processors does not include DIRA milk obtained from Fonterra to avoid double counting.

New Zealand: Overview of Dairy Processors (other than Fonterra)						
Company Name	Date Established	Company Type	Estimated Milk Processed 2008/09 Season 1/	Milk Accessed under DIRA 2008/09 Season	Estimated Milk Processed 2012/13 Season	Product Focus
			Millions of kilograms of milk solids			
Westland Milk Products	1937	Cooperative	45	0	50	Milk Powder, Butter, AMF, Caseins, Caseinates etc.
Tatua	1919	Cooperative	16.5	4.2	18	Caseinates, AMF, Specialty Products
Goodman Fielder		Corporate	20	20	20	Yogurt and Fluid Milk
Open Country Dairy	2007	Corporate	40	3	82	Cheese, Whey (low protein), WMP
NZ Dairies	2007	Corporate	15	4.2	24	WMP and Child Nutrition Products
Synlait	2008	Corporate	16	4.2	40	WMP, AMF, SMP and Nutritional Products
Mataura Valley Milk	Target date is August 2010	Corporate	0	0	16	WMP
Ingredients Solutions	In process of raising capital	Corporate	0	0	8	Caseins and Whey Protein
New Zealand Milk	In process of raising capital	Corporate	0	NA	NA	NA
Total			152.5	35.6	258	

Sources: Press reports; Agricultural Affairs Office estimates

1/ Includes 35.6 million kilograms of milk obtained from Fonterra under the Dairy Industry Restructuring Act. Terms for Goodman Fielder are different from those of other companies.

Note: To convert from millions of kilograms of milk solids to liters, multiply by 11.56.

Trade

New Zealand dairy product export volumes (excluding fluid milk) fell to 909,000 tons, a 9% drop, during the first seven months of MY 2008/09 compared to the same period last year. The biggest falls were in cheese, butter and butter oil, and whole milk powder; down by 21%, 10% and 4%, respectively.

On a volume basis (excluding fluid milk), the United States, Venezuela and China are the largest markets for New Zealand dairy products. On a value basis (USD), the United States, Japan and Venezuela are the largest markets.

On both a volume and a value basis, New Zealand's most important dairy export product is whole milk powder (WMP). The top New Zealand markets for WMP are Venezuela, Algeria and Sri Lanka. After declining for several years, China's imports of New Zealand whole milk powder have picked up significantly in recent months. If this trend continues, China could surpass Algeria to become New Zealand's second largest market in MY 2008/09.

New Zealand: Dairy Product Exports (Comparison between First Half of MY 2007/08 and MY 2008/09; Unit: Tons)									
PRODUCT GROUP	MY Year	JUN	JUL	AUG	SEP	OCT	NOV	TOTALS	% CHANGE
Consumer Products/Liquids	07/08	6570009	6461626	7449798	6886264	7947766	8432659	43748122	
	08/09	7742885	8685688	8033117	8703021	8632811	9256869	51054391	17%
Non-Fat Dry Milk	07/08	14520	14686	9392	13230	30427	29656	111911	
	08/09	15414	18853	14045	10831	25264	26791	111198	-1%
Whole Milk Powder	07/08	29094	26697	10841	48660	72527	71451	259270	
	08/09	42141	35052	22885	29661	60290	59835	249864	-4%
Milk & Cream Conc. NESOI	07/08	16	6	10	5	16	5	58	
	08/09	2	2	8	12	13	4	41	-29%
Yoghurt & Buttermilk	07/08	2548	1910	2002	2232	3817	4332	16841	
	08/09	1834	4402	2865	1883	3163	2728	16875	0%
Whey & Whey Products	07/08	5754	7307	4175	6650	8585	9550	42021	
	08/09	8617	7281	5524	5049	8285	11572	46328	10%
Butter & Butter oils	07/08	18258	16751	14589	21822	42067	37967	151454	
	08/09	20458	19915	18497	16915	36487	30148	142420	-6%
Ice Cream	07/08	1119	908	913	826	943	908	5617	
	08/09	865	795	900	764	691	808	4823	-14%
Casein & Albumins	07/08	7180	6845	4511	4544	10160	10985	44225	
	08/09	4587	3911	4013	4983	7317	9158	33969	-23%
Rennet And Rennet Concentrates	07/08	48	6	26	17	19	31	147	
	08/09	6	26	2	12	4	16	66	-55%
Cheese	07/08	27251	21686	18910	19013	25125	28748	140733	
	08/09	17716	15393	14740	16725	26164	25057	115795	-18%

Source: Global Trade Atlas

New Zealand Dairy Product Exports To United States									
Annual Series: CY 2003 - 2008									
Description	Unit	Quantity Exported						6 Year Average	% p.a. Trend
		2003	2004	2005	2006	2007	2008		
Consumer Products/Liquids	Liters	3481590	3294449	1983000	0	495750	901986	1692796	-54%
Non-Fat Dry Milk	Tons	812	791	596	200	204	86	448	-37%
Whole Milk Powder	Tons	3213	3691	2802	2919	1830	693	2525	-24%
Yoghurt & Buttermilk	Tons	127	0	0	0	1	66	32	-9%
Whey & Whey Products	Tons	171	15935	43104	48209	50289	47772	34247	148%
Butter & Butter oils	Tons	21334	34044	26366	24438	27851	20497	25755	-2%
Cheese And Curd	Tons	36671	36772	28997	29421	26356	16585	29134	-13%
Lactose Products	Tons	14	127	23	130	44	111	75	29%
Ice Cream	Tons	0	2	19	14	29	107	29	168%
Casein & Albumin Protein Products	T	73008	52989	46472	39737	49632	41979	50636	-9%

Source: Global Trade Atlas

Build Up of Inventories

The drop in export volumes has resulted in a supply chain problem for Fonterra and several newspaper articles have reported on the challenges Fonterra is facing to secure adequate storage space. According to one press report in December 2008, Fonterra was seeking the equivalent of 14 rugby fields of indoor storage space in the Auckland area alone.

According to Agricultural Affairs Office estimates, New Zealand's inventories of dairy products have approximately doubled since mid-year 2008 to somewhere in the range of 340,000 to 370,000 metric tons. The increase in inventories is primarily due to the global drop in demand, which has negatively impacted on prices, combined with an upturn in milk production during the first seven months of this marketing year. However, in recent newspaper reports, Fonterra executives have signaled that inventories have turned the corner and are now being run down. *(Note: Fonterra does not disclose inventory levels. Also, PS&D will be updated in the next scheduled report.)*

While statistics on the build up of stocks by commodity are not available, Fonterra is reportedly swapping production to products like butter and skim milk powder, partly because they have better long-term storage options for these products.

Policy Issues

DIRA to be Amended

In 2008, the New Zealand Ministry of Agriculture and Forestry (MAF) conducted a review of the raw milk regulations, which are part of the Dairy Industry Restructuring Act (DIRA). The milk regulations were put in place when Fonterra was created to facilitate entry of new processors into the domestic dairy market. The regulations, among other things, require Fonterra to supply individual independent processors with up to 50 million liters of milk annually at a regulated price. The regulated price is derived from a formula that is specified in the regulations. A cap of 400 million liters was put in place until the 2006/07 season, with increases to 500 million liters and 600 million liters in 2007/08 and 2008/09, respectively. The regulations also contain a sunset clause allowing Fonterra's commitment to supply milk at the regulated price to expire in 2013, or earlier if the sunset clause provisions are met.

The review of the milk regulations was prompted by strong demand from independent processors for regulated milk and a Fonterra and MAF concern that the regulations were consistently under pricing regulated milk. There was also a concern that DIRA did not contain adequate provisions to manage the risk associated with the transition period when the sunset clause kicked in and independent processors no longer had access to statutory milk supplied by Fonterra.

After completing the review, MAF recommended in August 2008 that Fonterra's farm gate price for milk become the default price for regulated milk as of June 1, 2009. MAF also recommended that the volume of regulated milk be kept at 600 million liters but that an auction system be implemented in 2010/11 to allocate regulated milk.

As part of the review, there were two rounds of consultations with industry participants and industry stakeholders. Reportedly, while Federated Farmers and Synlait Dairies Limited supported MAF's proposal (with some caveats), most independent processors favored retaining the default pricing formula while substantially increasing the quantity of raw milk made available. In comparison, Fonterra wanted a smaller quantity of regulated milk at a substantially higher price. Independent processors expressed concern about the ability to secure raw milk on competitive terms in a post-DIRA environment. The Commerce Commission expressed concern from a competition policy perspective regarding any move away from the default pricing formula as well as the introduction of an auction as prices could potentially be manipulated and it could be difficult for independent processors to secure raw milk on competitive terms in a post-DIRA environment. The Commerce Commission suggested that the sunset clause levels should be substantially increased and that there should be a five-year phase-out period.

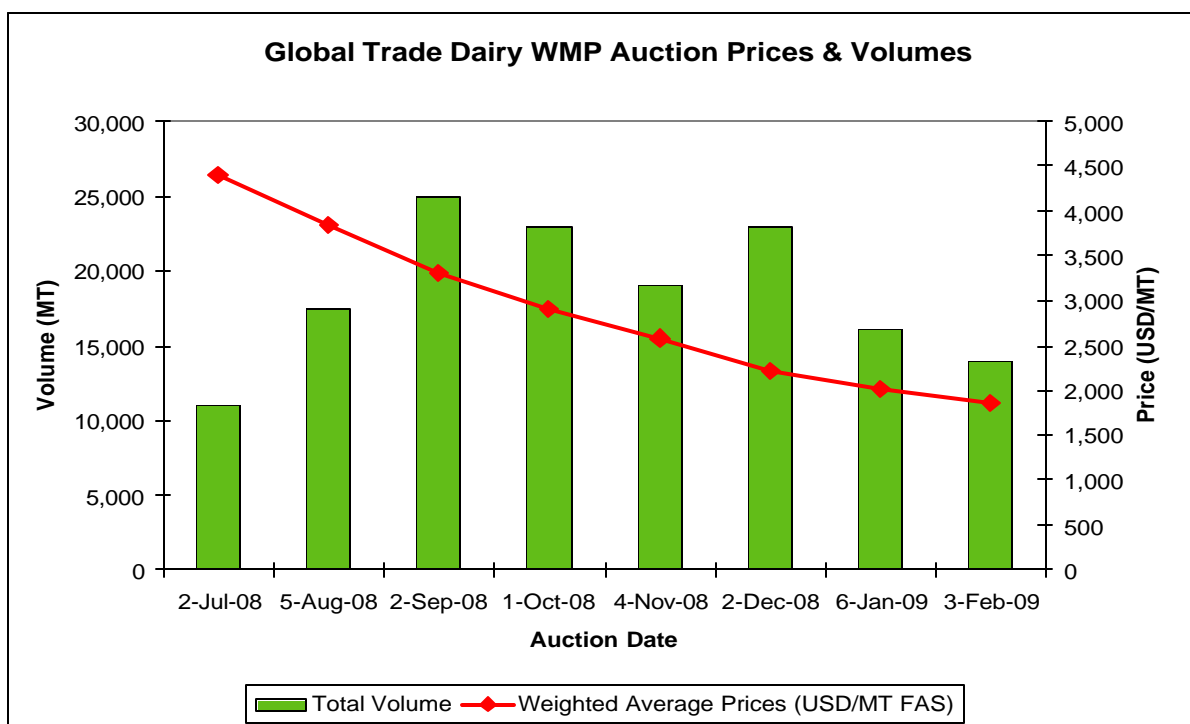
The recommended changes that MAF put forward in August 2008 required legislative amendments to DIRA. As such, the decision was postponed to give the new National-led government, which came to power in November 2008, time to review them. The MAF Minister is reportedly reviewing the proposed changes and, if he is in agreement, will introduce a bill in parliament. Given the concerns voiced by stakeholders and the Commerce Commission, the new government will be under pressure to come up with a system that satisfies all stakeholders and industry participants. (Please see GAIN Report NZ8026 for additional background information.)

Fonterra Whole Milk Powder Auction System

Fonterra implemented a controversial auction system, known as Global Trade Dairy, in July 2008, which has fast become an industry-accepted reference price for whole milk powder (WMP). Initially, Fonterra indicated that it intended to sell approximately 10% of its domestic production of various commodities through the auction. However, to date, the auction has been limited to just three specifications of WMP. Looking at volumes sold to date, Fonterra will likely sell 25-30% of its annual production of WMP through the auction system. On a volume basis, this equates to about 10% of total Fonterra production.

Since the system was implemented, the average selling price for whole milk powder has plummeted 58% from US \$4,395 per ton in July 2008 to US \$1,851 on February 4, 2009. Internet auction prices fell 14% in December, a further 9.3% in January, and an additional 8.2% in February's auction.

Competing dairy companies have complained that the auction system has accelerated the decline in prices arguing that it has turned Fonterra from a price-maker into a price-breaker. They have also suggested that Fonterra is using the auction system to enhance its position with New Zealand dairy farmers by strengthening its dominance over the growing number of competing dairy companies and to compensate for the poor performance of its added value business. According to Fonterra, the auction system is working well. In a recent statement, Fonterra representatives said that it is achieving what it was developed for – enabling price discovery of commodities in an increasingly volatile market. However, in response to the most recent auction, a Fonterra executive was reported in the New Zealand Herald as saying “Prices should be very attractive to buyers at these levels, and they are not sustainable for global suppliers.” While many analysts have indicated that the market is close to finding a floor, the recent announcement by the EU regarding the reactivation of export subsidies could drive price down further.



Fonterra's Plans for Capital Restructuring

Fonterra's Board has reported that work on new proposals for capital restructuring is on-going. An initial opportunity for shareholders to vote on a capital restructuring proposal had been planned for May 2008, but the decision has been deferred to allow Fonterra to engage in further discussion and consultation. Fonterra's board has reportedly agreed to thoroughly test any proposed future capital moves with the shareholders' council before releasing them to member and public scrutiny.

Fonterra Writes Down San Lu

In 2005, Fonterra acquired a 43% stake in San Lu, the dairy company at the center of the recent melamine scandal. At the time, it was one of the largest investments by a foreign company in the Chinese dairy industry. Since the melamine scandal broke, Fonterra has completely written off its NZ \$200 million investment in San Lu and the company has been put into receivership. In New Zealand media columnists have focused on the likelihood of Fonterra's culpability and the potential impact on Fonterra's brand image. (Please see GAIN Report NZ026 for additional information.)

New Zealand Response to EU Dairy Subsidy Announcement

New Zealand Trade Minister Tim Groser has characterized the EU's decision to reactivate dairy export subsidies as "totally irresponsible". He was quoted in press reports as saying that it makes a mockery of the G20 declaration of November 15, 2008 that says those countries would refrain from raising new barriers to investment or to trading good and services. Fonterra officials have also expressed concern that the EU decision will drive dairy prices down further and add to uncertainty and instability in the market. New Zealand press reports have warned of "copycat behavior" if other countries follow suit or if the EU opts to extend subsidies to include other commodities. Likewise, the concern has been raised in the New Zealand media that the EU decision may provide ammunition for the United States to loosen restrictions on what can be subsidized. It has been reported in New Zealand that some EU officials point to the introduction of Fonterra's auction system and the way it has been managed as a driver for the decision to reactivate dairy export subsidies.

Appendix I. Relevant Reports Submitted by the Agricultural Affairs Office

Selected Reports Submitted by the Agricultural Affairs Office Wellington, New Zealand		
NZ9001	NZ Dairy Cooperative Fonterra Reduces Milk Payout	January 29, 2009
NZ8026	Annual Dairy Industry Report	October 20, 2008
NZ8024	Chinese Infant Formula Contamination Involves Fonterra	September 19, 2008
NZ8022	New Zealand and Australia Sign an FTA with ASEAN countries	September 2, 2008
NZ8020	Beef and Cattle Annual Report	September 3, 2008
NZ8009	Semi-Annual Dairy and Products Report	May 15, 2008
NZ8007	New Zealand Announces FTA with China	April 17, 2008
NZ8003	Impact of Drought on New Zealand Milk Production	March 11, 2008